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IN THE

Supreme Court of the United States

OCTOBER TERM, 1965

No. 922

KARL F. KNETSCH AND EVA FAY KNETSCH, *Petitioners*,

v.

UNITED STATES OF AMERICA

PETITIONER'S REPLY BRIEF

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When, in 1959, petitioners asked this Court to allow them annuity interest deductions for the years 1953 and 1954, the Solicitor General argued against the allowance of any part thereof and told this Court that when Internal Revenue Service officials stated to Congress that they had *allowed* taxpayers who had purchased similar annuities a deduction for their "net out-of-pocket expense", those officials meant "net out-of-pocket investment". The Solicitor General then immediately equated "net out-of-pocket investment" with "a *loss* deduction based upon [taxpayer's] out-

of-pocket *loss* incurred at the time of termination of his contracts".[1]

If, as petitioners submit it is, it is wrong for the Attorney General to tell this Court that civil contempt is not a crime while at the same time advising the Department of Defense that it is, then certainly it is equally wrong for the Solicitor General to tell this Court that the same statement of policy made by the Commissioner of Internal Revenue meant one thing in 1959 (in order to prevail in the first *Knetsch* case) whereas he now tells the Court that it meant

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[1] Brief for the United States, Knetsch v. United States, No. 23, October Term, 1960, pp. 50-51:

"... Those officials did not say that the recipients of ruling letters would be exempted entirely from the retroactive effect of Rev. Rul. 54-94, *supra*. Mr. Swartz stated that (p. 192)—

> we would allow them a deduction for the out-of-pocket money they have spent, not the full interest deduction, but the extent to which they had relied on it [the ruling letter] to their detriment. * * * We allowed a deduction to the extent of the net out-of-pocket expense.

In the case at bar, as we have seen, the taxpayer's net out-of-pocket expense, his investment in Sam Houston, was far less than the claimed deductions for "prepayments of interest". Even if his position were deemed identical with that of recipients of the ruling letters, the Commissioner would allow deduction only of his net out-of-pocket investment in Sam Houston. Taxpayer has indeed claimed (in his 1956 return) a loss deduction based upon his out-of-pocket loss incurred at the time of termination of his contracts with Sam Houston. But that claim is not a part of this case and, whatever its merit, it is obviously discrete from the much larger claim (here involved) predicated upon the payment of "interest" during the period prior to termination.[14]

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[14] The claim advanced by taxpayer in his 1956 return is still pending before the Commissioner."

exactly the opposite (in order to prevail herein).[2] That is, the Solicitor General, at the time petitioners sought annual interest deductions as a result of the instant annuity transactions, told this Court that if petitioners were entitled to anything, it was only a net out-of-pocket *loss* deduction realized upon termination of the annuity contracts. However, now that petitioners seek that net out-of-pocket loss deduction realized upon termination of the annuity contracts, the Solicitor General, at page 8 of his brief in opposition, volte face, tells this same Court that the Internal Revenue Service officials meant that they had "allowed" not net out-of-pocket loss deductions but "so much of the *interest* payments as did not exceed their out-of-pocket costs" each year.

Not only does this "new" view of the Solicitor General undermine this Court's decision in *Knetsch* v. *United States,* 364 U.S. 361,[3] but it is contradicted by the concession made by the Government herein (in its motion for summary judgment) that the Internal Revenue Service had allowed a net out-of-pocket *loss.*

Furthermore, earlier this term the Solicitor General asked the Court to review *International Business*

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[2] The two conflicting statements are contained in separate briefs submitted by the Government in which the same Department of Justice attorney appears as counsel. Therefore, such contradictory statements cannot even be explained on the ground that different counsel were responsible therefor.

[3] Since this Court's decision and opinion therein disallowed *all* of the claimed interest deductions, this new argument of the Solicitor General that the taxpayers were entitled to and allowed an "interest" deduction each year equal to their net out-of-pocket loss is in conflict therewith. It is also in conflict with the facts since, as this Court well knows, there was no allowance by the Commissioner in Knetsch v. United States, 364 U.S. 361 of any part of the claimed interest deductions.

Machines Corporation v. *United States,* 343 F. 2d 914,[4] —a case in which the Court of Claims had applied the doctrine of "equality of treatment of taxpayers similarly situated" in favor of the taxpayer therein. In seeking review thereof for the purpose of obtaining a determination by this Court of whether or not there is such a doctrine of tax law and, if so, the extent of its applicability, the Solicitor General invoked ominous phrases such as "The courts basic holding . . . has *far-reaching implications,*"[5] and "the decision below poses a *serious threat* to the continued operation of the Commissioner's important rulings program . . .".[6] He also postulated the hypothetical danger that ". . . the courts may reason that if taxpayers are entitled to equality, they also are entitled to discover how other taxpayers have been treated," and concluded that "such a view would result in extensive discovery of documents filed with the IRS . . .".[7] Since the instant case affords an opportunity for a review of the same doctrine of law, having the same "far-reaching implications," it is surprising that the Solicitor General now objects to the granting of certiorari herein.

It is also surprising that the Solicitor General has neither responded to nor answered most of the reasons set forth by petitioners as to why certiorari should be granted. The most significant omission in the Solicitor General's brief in opposition is his failure

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[4] United States v. International Business Machines Corporation, No. 820, October Term, 1965.

[5] Ibid., at p. 14.

[6] Ibid., at p. 17.

[7] Ibid., at p. 15.

to explain how the Court of Claims could have granted the *Government's* motion for summary judgment in view of the facts which had been conceded to be true by the Government for the purposes of that motion, and which concessions it did not deny in its brief in opposition herein. The Government had conceded as *true* that the Commissioner of Internal Revenue told the Congress in 1957 that "while *interest* deductions claimed in regard to annuity transactions were being *denied* taxpayers who claimed same" he "was, as a matter of policy, *allowing* such taxpayers a deduction for their net out of pocket *loss realized* from such annuity transactions where the taxpayer had acted in reliance on references to trade magazines and the tax services to the issuance of private rulings by the Treasury Department stating that interest paid in connection with such annuity transactions was deductible for income tax purposes." It was also conceded as true that Knetsch had acted in reliance on such references to private rulings.[8] The application of the doctrine that "taxpayers similarly situated should be accorded equal treatment" to such conceded facts requires a ruling in favor of taxpayers and thus precluded the granting of summary judgment in favor of the Government.

In addition, the Solicitor General has neither responded to nor answered the following additional reasons why the writ should issue:

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[8] The Solicitor General is being less than accurate when he attempts to leave the inference at page 9 of his brief that the only ruling relied upon by Knetsch was the Salley ruling. See allegations contained in paragraphs 5 and 6 of Petition (R. 2-3) which were admitted as true for purposes of the Government's motion. See further, the deposition of Knetsch contained in the Record, together with the rulings attached as exhibits thereto.

1. The Court of Claims abused its discretion by refusing outright to grant plaintiffs leave to amend without setting forth any justification whatsoever for such action. (Such action conflicts with this Court's decision in *Foman* v. *Davis*, 371 U.S. 178.)[9]

2. The Court of Claims erred in granting the Government's motion for summary judgment while plaintiffs' motion to amend their petition (complaint) was pending. (Such action conflicts with the decisions of at least three circuits.)[10]

3. The Court of Claims erred in granting the Government's motion for summary judgment where ultimate facts respecting motive and intent must be made. (Such action conflicts with the decisions of this Court and those of at least two circuits.)[11]

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[9] Petition for Certiorari, Point I, pp. 5-7. Such failure on the part of the Court below is not cured by the Government setting forth in its brief in opposition herein its present views as to why the said motion to amend should not be granted. As to the merits of the argument now presented by the Government, it should be noted that the statute of limitations does not bar an amended claim for refund which does not present new or unrelated matters or facts which the Commissioner was not on notice of, but merely asserts new legal theories of recovery. Consolidated Coppermines Corporation v. United States, 296 F. 2d 743, 155 Ct. Cl. 731. Furthermore, the 1954 Code provides a theft loss is deductible in the year in which it is discovered and not the years in which it may have occurred (Sec. 165 (e)). "The right to take the loss will not be defeated by the fact that the taxpayer has a right of action against irresponsible persons", and he need not first exhaust his legal remedies against the culprits. 5 Mertens', Law of Federal Income Taxation, Sec. 28.59.

[10] Ibid., Point II, pp. 7-8.

[11] Ibid., Point III, pp. 9-10.

4. The Court of Claims erred in drawing repeated fact inferences as to the intention of Knetsch and Harold T. Swartz on a motion for summary judgment. (Such action conflicts with the decision of at least three circuits.)[12]

5. The Court of Claims erred in granting the Government's motion for summary judgment since genuine issues of material fact were present. (Such action conflicts with the decisions of this Court.)[13]

6. The Court of Claims erred in granting the Government's motion for summary judgment since, viewing the underlying evidentiary facts in the light most favorable to plaintiffs, inferences contrary to those drawn by the trial court might be permissible. (Such action conflicts with the decisions of this Court.)[14]

7. The Court of Claims erred in not applying its doctrine of equitable estoppel so as to prevent a wrong being done since "in good conscience and honest dealing" the Commissioner ought not to be permitted to repudiate his previous statements and declarations to Congress. (Such action conflicts with the Court of Claims' decisions.)[15]

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[12] Ibid., Point IV, pp. 11-15.

[13] Ibid., Point V, pp. 15-17.

[14] Ibid., pp. 14-15, 17.

[15] Ibid., pp. 19-20. The Solicitor General has misstated this argument (p. 11, n. 6). Petitioners seek the same deduction which the Commissioner told Congress he had allowed other taxpayers who had not themselves been issued a ruling, but who had relied on the position taken by the IRS in other private but publicized annuity interest rulings. The Commissioner has never taken the position, publicly at least, that he had been in error, as a matter of law, when he made that statement to Congress.

8. The Court of Claims erred in rejecting the long-established rule that the profit making motive and intention of a taxpayer required under section 165 is a matter of subjective intent, and in fashioning and following a new rule that such motive or intention is to be determined from *objective* factors.[16]

9. The Court of Claims erred in fashioning and applying a new rule of tax law, to wit, "there can be no deductible loss allowed under section 165(c)(2) if the transaction which gave rise to the loss has been determined to have been 'without economic substance' or a 'sham'."[17]

10. The effect of the decision below is punitive in nature and permits the Commissioner to realize a net profit after he has been instrumental in causing taxpayers to be misled to their detriment.[18]

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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[16] Ibid., pp. 20-21.

[17] Ibid., pp. 21-22.

[18] Ibid., pp. 22-23.